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THE INVESTOR'S INTEREST IN RAILROAD VALUATION

Physical valuation of railroad assets has been made at various times for four distinct purposes. Condemnation proceedings in connection with takings by the public and appraisal for purposes of taxation were among the first. In recent years such inventories have come to be common in connection with the determination of reasonable rates. And, last in series, an interest has arisen in such physical valuation in connection with the regulation of the issue of securities. These latter phases of the matter have brought the movement into more and more intimate relationship with the welfare of investors. For these reasons it is pertinent to inquire at this juncture as to the nature of the effect, direct or indirect, of this form of state activity upon private property rights. And such an inquiry is peculiarly important in view of the prevalent financial embarrassment of American railroads as a whole, and the especially precarious condition of a few important ones among them. The federal government is even now in the act of expending from twenty to fifty million dollars for the purpose of making a physical inventory of the railroads of the United States. Of what value will this stupendous undertaking be to the thousands of stock- and bondholders of the properties concerned?

That the attitude of the railroads toward public valuation has completely changed upon further acquaintance with its methods, aims, and results is quite explicable upon examination of the course of events. Hostility was once extremely pronounced. Valuation was assailed, not only as unscientific in theory and unnecessary and impossible of practical application, but also as socialistic or revolutionary in tenor and results. A fusillade of invective was directed ten years ago against every experiment in this direction. This was partly due to the suspicion attaching to ignorance; it was partly warranted by the fear lest publicity in this direction should increase the burdens of taxation.¹ Notoriously overcapitalized

¹ *Bull. 21*, U.S. Census, 1904, on "Commercial Valuation," showed that the tax assessment in Connecticut only was equal to the market value, while in other states the relationship ranged down to that in New York, where assessment valuation was only one-quarter of the commercial valuation.

properties also dreaded the effect of publicity in the matter of rates. The railways seem now to have executed an about face; so much so that on the occasion of the enactment by Congress of the federal valuation law no corporate opposition whatever was presented. This change of opinion has followed a gradual appreciation of the protective value to vested interests of a complete revelation of all the existing financial facts. Technical railroad men have learned this in advance of the banking interests. We may at all events interpret the lack of apprehension, nay, even the appearance of lukewarm interest in the results, as proof that physical valuation is capable of rendering a real service to those who own the securities of the railroads of the country.

Viewed in a large way, physical valuation is only a phase of sound accounting practice, which in turn is nothing more than one aspect of publicity. Appreciation of the corrective and remedial value of corporate publicity is steadily increasing. The accounting clauses of the federal railway law of 1910, conferring authority upon the Interstate Commerce Commission really to enforce the provisions of the act of 1887, are among the most important phases of that legislation. Less pretentious than some, to be sure, they are none the less fundamental features of any program of regulation. They are not only productive of honest and efficient operation, serving the public thereby, but they also emphasize and enforce an all-too-imperfect sense of accountability or trusteeship of managements to investors. But sound accounting calls for an inventory of assets, thoroughly made and kept currently up to date by means of a running record of all financial transactions as a primary requisite. This will be illustrated by means of concrete examples chosen from certain of the most difficult and least understood phases of bookkeeping.

The first item on the balance-sheet under the head of assets—set off against the outstanding capitalization on the opposite page as liabilities—is “cost of property.” This is the foundation stone of the accounts—the only actuality; all else is merely paper. How many railroads at the present time are warranted in the assumption that any real relationship whatever between the physical assets and this item on the book exists? In an old seasoned property

this lack may well be forgiven, details having reached the vanishing point in historical perspective. But even for the most recent enterprises, in how many cases may it be affirmed that this item is a true statement of fact? Every accountant is well aware that "cost of property" is veritably a catch-all and drag-net on the balance-sheet; as much so, indeed, as "profit and loss," which, at the foot of the column, is so often utilized to even up whatever discrepancies may exist between liabilities and assets. The only difference is that cost of property, stretching back over a long period of years, may be fudged with greater impunity than "profit and loss," which is linked up somewhat more directly with recent events through the income account.

The Chicago, Milwaukee & St. Paul, in connection with its transcontinental extension in 1910, has recently afforded an unanswerable argument in favor of physical valuation for the purpose of assuring a real value to "cost of property" upon the books. Without either the knowledge or consent of its shareholders it deliberately falsified this item, possibly with the mistaken view that indirectly the general shareholders might benefit in future years. But the operation also seems not unconnected with what bears every appearance of speculation by insiders in the securities of the company. The facts, as set forth in the official opinion of the Interstate Commerce Commission,¹ had already come to my attention in connection with a fiduciary interest as investor in the outcome of this great piece of construction. Three separate letters were addressed in this capacity to the president and treasurer respectively, the receipt of which was not even acknowledged. Is it any wonder that the utterly helpless, isolated shareholder should seek aid and solace from the federal government, which alone possesses the power to compel a disclosure of the truth? The facts were these: The total cost of construction of some 1,700 miles of line was in the neighborhood of \$155,000,000. This sum was advanced to the Puget Sound Company in exchange for its bonds, the cash in first instance being raised by subscription to new stock of the old St. Paul Company by its own shareholders. No other source of funds existed. Yet in the first annual report of the Puget

¹ 29 I.C.C. Rep. 508.

Sound Company, for 1910, property investment appears on the balance-sheet at \$236,000,000. One year later this valuation was raised to \$269,000,000. A profitable investment indeed which can enhance in value at such a rate as this! The explanation as to the discrepancy between a cash outlay of \$155,000,000, more or less, and a book-value of \$269,000,000 was simple. The Puget Sound Company had paid for its entire property by sale of its bonds at par, mainly to the parent corporation, and had thrown in \$100,000,000 of capital stock for nothing in order to give good measure. Obviously the liabilities' side of the balance-sheet was puffed out by this \$100,000,000 of capital stock put forth gratis. The only way thereupon to bring the assets to an equivalence was to write them up correspondingly. That was the bookkeeping excuse.

Certain provisions of law had a bearing upon the St. Paul case. The Puget Sound Company was a Washington state corporation. The statute limited the issue of bonds to double the amount of the capital stock. The law, following the rule in most other commonwealths, also forbade the issue of capital stock except for an equivalent at par in cash or property. If all funds were to be raised from bonds, allowing a sufficient margin for unforeseen contingencies and preserving the requisite relations between bonds and stock, there was no alternative to the issuance of this large amount of stock. And, moreover, in order to meet the second provision of law in form, although manifestly not in substance, the property valuation must be made sufficiently large to equal both bonds and stock. The simplest way, therefore, was adopted. The property valuation was written up sufficiently to meet the needs of the case. An added advantage lay in the possibility of distributing larger earnings in future without risking the appearance of inordinately high profits. Had all construction accounts been under the jurisdiction of the Interstate Commerce Commission, and had a certified physical inventory of assets been made by proper authority, the St. Paul management would have been debarred from this wilful deception of the public and of its own shareholders alike. It would have been a perfectly simple matter for the parent company to have accepted part payment for its advances of cash in capital

stock at par, the balance being provided for in bonds. The prescribed relationship between stock and bonds could have been preserved throughout. This might not have been feasible had the offering of Puget Sound securities been made to the general public. It might have been necessary, as so often in the past, to stimulate an appetite for the bonds. But in this instance the taking of both the stock and the bonds was assured. They all went into the treasury of the St. Paul Company by prearrangement. The difference would have been this: that the total outstanding capitalization of the Puget Sound Company would then have been equal to the actual cost and, in view of the recency of construction, to the then commercial value of the property. The whole episode constitutes an exceptionally strong argument in favor, not only of physical valuation, but also of including all accounts of construction companies along with operating railroads under the jurisdiction of the Interstate Commerce Commission.

The confidence of investors throughout New England in the honesty of railroad management has been severely shaken by the recent financial collapse of the once great New Haven system.¹ Fortunes have been lost and helpless widows and orphans rudely deprived of their much-needed incomes. There can be no doubt that an official appraisal of this property made a decade ago would have prevented all of this loss, or at least some part of it. Within nine years to 1912 the capitalization of this railroad increased from \$93,000,000 to \$417,000,000 without an appreciable addition to the mileage. About \$340,000,000 was procured from the sale of stocks and bonds during this time. Out of this, \$40,000,000 was expended for the purchase of previously leased lines and \$96,000,000 was expended for betterments and equipment. The balance, amounting to about \$204,000,000, was invested in properties outside the steam railroad sphere—in trolley lines, steamships, power plants, and even newspapers. Every interest of the stockholders was recklessly disregarded. A capital stock once commanding \$200 a share, and for years regularly in receipt of 8 per cent dividends, is now quoted at less than one-fourth that

¹ Ripley, "Railroad Overcapitalization," *Quarterly Journal of Economics*, August, 1914, p. 619.

figure; and it will be years before any return whatever upon the investment can be had.

The New Haven disaster at root was due to an attempt to create a transportation monopoly regardless of cost. Competitors were purchased at prices in nowise conditioned either by earning power or by tangible assets. Thus, for example, the trolley lines in Connecticut cost about \$40,000,000 in New Haven securities. The New Haven paid at least one-third more for them than they were possibly worth. The acquisition of the Rhode Island trolley lines was equally reckless and improvident. As Commissioner Prouty tartly put it in his official report,¹ the Rhode Island company "turned in the water and the New Haven converted that water into wine. In whatever aspect the transaction is viewed, the New Haven gave \$13,500,000 for nothing." Similarly, in the Westchester enterprise, another four-track electric road out of New York, the New Haven invested \$35,000,000 in construction against tangible property since officially valued at about one-third of that amount. All these transactions seem to have taken place without any considerable measure of oversight or approval, and in some cases without even the knowledge, of the Board of Directors. Can there be any question that if an official state inventory of these properties had been available for the purpose of checking up results, these purchases at extravagant prices would have been prevented? In several instances where such matters came under the jurisdiction of the New York Public Service Commission proceedings were at least delayed by the publicity afforded through a valuation made by governmental authority.²

The service to investors of complete publicity as to the physical value of properties concerned in corporate consolidations is emphasized also in the recent "Frisco" receivership.³ Here, again, a board of directors, instead of being actuated by a sense of trusteeship to their stockholders, proved faithless in this regard. As in the New Haven affair, subsidiary properties were acquired at

¹ 27 I.C.C. Rep. 581.

² Ripley, "Public Regulation of Railroad Issues," *American Economic Review*, September, 1914, p. 548.

³ Ripley, *Railway Age Gazette*, LVI (1914), 1226.

exorbitant prices, entirely incommensurate with either their cost or their earning power. But in this instance many of the lines were branches or feeders, constructed by insiders in the management, headed sometimes even by the chairman of the Board of Directors. These were afterward unloaded upon the parent road for much more than they were worth. A notable example was the Brownsville, Texas, extension, which cost \$8,900,000. For this the "Frisco" was made to pay \$12,100,000, the profit to the promoters being 75 per cent upon the investment. The need of submission of construction company accounts to public control, and especially of their being checked by a technical inventory of the assets, is as evident as in the case either of the St. Paul or of the New Haven company.

A moment's consideration of the nature of surplus in corporate accounts will also bear testimony to the significance of physical valuation to the investor. A surplus, although seemingly substantial enough, is in reality a hazy and illusive thing. It depends entirely upon the valuation placed upon assets; and it may be obliterated by a stroke of the pen in writing off property account. Particularly misleading may be such a surplus if, instead of being in cash or securities, it is a mere statement of past earnings invested in the property and appropriated to future usefulness. It may be, and often is, a guaranty for the continuance of dividends during hard times; but it may also be so inextricably invested in the plant that it cannot readily be made serviceable in time of need. One important American railroad at the present time, having a considerable surplus, is paying its dividends in script for want of ready cash. The growing practice, moreover, among public-service commissions is to regard surplus, not as the private possession of the corporation, but rather, according to the public-spirited policy voluntarily adopted by the American Telephone Company, as a reserve, "indivisible, inviolable, and inalienable," to be administered for the joint benefit of the stockholders and the public in future years.¹

But whatever one's conception theoretically of the nature of surplus may be, there is a very real danger to investors of having

¹ *Annual Report*, 1912.

a reserve created out of the undivided earnings of past years capitalized by an unscrupulous management, which may thereupon foist the new securities upon an unsuspecting public. The most notable instance was the reorganization of the Chicago & Alton in 1898 by the late E. H. Harriman and his associates. Here, again, railroad securities once quoted at double their par value are now bandied about from hand to hand at merely nominal prices.¹ The old Alton road had a surplus of \$7,000,000 in 1898. Within seven years its capitalization expanded from \$34,000,000 to \$114,000,000, while the real property acquired was worth only about \$18,000,000. To make a long story short, \$62,600,000 of bonds and stocks were put forth for no tangible equivalent whatever—an amount equal to \$66,000 per mile of line. The average capitalization per mile of the railway net in the United States is less than \$60,000. At bottom, this operation was put through by converting the sound credit and high reputation of the previous management into securities supported by no commensurate increase in the actual investment. Incidentally it may be noted, as bearing upon the previous comments upon “cost of road,” that within the seven years covered by the Harriman management this item on the balance-sheet swelled from \$66,000,000 to \$117,000,000. It seems unquestionable that if these transactions had been carried on under adequate governmental supervision of accounts, checked as to details by a structural inventory of the property, the huge private fortunes, accumulated at the expense of the unwary investor, would have been in some measure at least prevented.

All of the foregoing argument, it may be objected, proceeds upon the assumption that commercial value is really determined by structural worth rather than earning power, and that, after all is said and done, what interests the investor is not the sacrifice entailed in the creation of a property—a sacrifice borne, perhaps, by previous and transitory owners of the securities—but the tangible returns in the way of profits from operation, present or prospective. The point is entirely well taken; but, instead of weakening, it really reinforces our contention. However largely from the public point of view, principally in connection with the

¹ Ripley, “Physical Valuation,” *Political Science Quarterly*, December, 1914.

establishment of reasonable rates, attention may focus upon actual or reproduction cost of the plant, to the owners of the shares and bonds the directly pertinent inquiry is how productive it may be of revenue. But even here, it is submitted, the investor has a direct interest in physical inventory. Every detail of financial policy, whether in time of corporate health or indisposition, hinges upon the relationship between the physical condition of the assets and their earning power. A property may be just as good for service to the public or for earning dividends for investors after fifty years of existence as when new. Whether it is or is not depends entirely upon the policy as to depreciation which has been pursued. Yet, while for a time depreciation may be a mere matter of accounting, it is imperative that the accounts be squared periodically with the physical facts. Matters may drift unwittingly into a ragged condition, deceptive alike to the public and to the owners.

Two illustrations of the danger to investors of an improper depreciation policy lie at hand. One is the financial failure of the Boston & Maine; the other is the bankruptcy of the once prosperous Rock Island road. In both instances their present troubles have resulted from failure, ignorant or wilful, to charge replacement outgo in sufficient measure to income rather than to capital account. Both alike have been for years distributing their capital as dividends among shareholders, who were in turn devoting these dividends to current personal expenditure, in entire ignorance of the real facts. The Rock Island affair is the more flagrant of the two. The facts came to light in 1914 in connection with reorganization proceedings. The management had promulgated a statement indicative of a liberal upkeep of roadbed and equipment. Vice-President McKenna of the St. Paul road was called in to investigate the matter from another angle for the bondholders. His report disclosed a starvation policy so extreme that one-half of the company's freight cars were found to be fit only for the scrap heap. No fewer than 20,000 of them, it was reported, ought to be replaced at once at a cost of \$15,000,000. Inadequate or deferred maintenance-of-way work called for an additional expenditure of \$8,000,000. Thus was a reported surplus of \$13,600,000 converted

into a deficit of over \$10,000,000. An official stock-taking carefully made and rigidly checked from year to year during the last decade would have put a stop to the deception and loss which such management entailed upon those whose savings had been invested in the enterprise.

There being so many distinct purposes of physical valuation, it is pertinent to inquire how far the same principles apply interchangeably. Is an appraisal for condemnation or taxation serviceable in rate or capitalization cases; and which one of these may be relied upon most confidently to inform the investors of the condition of their property? The trend in most court and commission rate cases now seems unmistakably toward the adoption of actual or original cost; although reproduction cost has played so prominent a part in such proceedings in the past.¹ In rate cases, certainly, the entire corporate life from beginning to end must be included in the ascertainment of the real sacrifice made by investors in the enterprise. But it would seem as if the interest of the investor at a given time were more direct and immediate. Not what it costs to create and upbuild the property, but what it may now be expected to yield in revenue, is of primary importance, as we have already seen. The innocent third party, or in other words, the eleventh-hour stock- or bondholder, acquires his interest at a price which capitalizes future prospects and ignores entirely the events of the past. To him, looking forward alone, the present status of his investment, including its guaranty for future returns, outweighs all other considerations. Undoubtedly some investments there are which still hold over from the beginning of the enterprise; but they tend constantly toward a vanishing minority. And, of course, wherever reorganization has occurred they have entirely disappeared. The contrast between this point of view and that of the state, which has no limited existence, is in all respects striking. Fortunately the newer valuations, notably that of the federal government now under way, seek data both as to original cost and as to present condition. The results in the first category may be used for rate purposes, while those of the second are placed at the disposal of the investing public.

¹ Ripley, "Physical Valuation," *Political Science Quarterly*, December, 1914.

An attempt to differentiate the methods and principles of valuation according to the purpose in view might be indefinitely extended were consideration to descend to details. One or two may, however, be mentioned in passing. The worth of a going concern, as distinct from franchise value, deserves quite different treatment in a condemnation case from that concerning rates or capitalization; and the viewpoint of the private investor may differ widely from either of the other two. "Hot assets" are certainly worth more than "cold assets" for revenue purposes, however little they may have differed in respect to the sacrifice at some time made by those who called the property into being.

The viewpoint of the investor, as distinct from that of the public-service or taxation commissioner, is most clearly defined in condemnation proceedings for the taking of property for public use. A commercial valuation based upon earning capacity is final and all-important; while in rate cases attention is focused, not upon the fair value of the property alone or a fair rate of return, but upon the product of the two. Physical valuation is an incidental detail in the ascertainment of fair rates. It is fundamental in fixing values when the property is to change hands once and for all. Yet, on the other hand, the element of depreciation confounds this argument. Depreciation becomes relatively unimportant unless it affects the quality of the service. Some experts maintain that it should for this reason play no part whatever in valuation for rate-making. But it certainly looms large in condemnation proceedings; and it would appear to be of the utmost importance in all examinations of property, made for the purposes of informing security-holders as to the stability of their investment.

The results already obtained from physical valuations in the different states promise substantial protection to the investor against further reduction of rates, and even afford some ground for the belief that a demand for increased returns would be upheld by the courts upon the basis of this evidence.¹ The range of these valuations between the different states is very wide. At one extreme, Texas finds the present value to be \$22,000 per mile of

¹ These results are tabulated in detail for the leading states by the author in the *Political Science Quarterly* for December, 1914.

line; and at the other, New Jersey finds it to be \$167,000 per mile of line. The most important relationship is that between physical valuation and capitalization. The returns in this respect indicate with marked unanimity that the outstanding stocks and bonds of railroads at the present time are fairly represented by the worth of their physical possessions. For five states taken together the inventory value new is \$142,000,000 in excess of the outstanding securities at par. This calculation makes no allowance for depreciation; but, at the same time, it includes nothing for the value of a going concern. In practice it has been found that these two items about offset one another. Taking the returns state by state, the evidence is conclusive that there is a comfortable margin of real value over and above the existing capitalization. This by no means implies that individual companies have not erred grievously in this regard; but the data will materially assist in counteracting the impression so widely prevalent at one time that American railroads as a whole are very much overcapitalized. If physical valuation by the government contributed nothing more than this to a proper understanding of the situation by the people at large, and particularly by the courts which are charged with the determination of rate reasonableness, the undertaking would have been well worth while.

The merchant and manufacturer commonly find it advisable to make an inventory of their possessions at stated intervals. Nothing else so clearly reveals the need of writing off for depreciation as a periodical account of stock. Because a railroad is a much larger enterprise is it any reason why this safeguard of conservative accounting should be ignored? Moreover, depreciation constitutes a particularly acute problem in railroading. Obsolescence is especially severe under modern conditions. One of the leading efficiency engineers has aptly described the situation as follows:

Roadbeds do not wear out any more, they are realigned with grade revisions; ties do not gradually decay, they are cut to pieces by the heavy traffic; rails do not last their life, they are displaced by heavier sections; stations do not wear out, they have to be torn down to make way for palatial structures; round-houses are scrapped because electrical equipment has come in; locomotives used to last fifty years, the average age of locomotives in actual

freight service now is not over ten years; wooden passenger cars make way for steel cars. A 2 per cent assessment made once used to be sufficient for depreciation. It is a question whether 3 per cent a year will take care of modern obsolescence.¹

How many corporations have squarely faced this situation? Is it not a matter of congratulation that all of them are now compelled to do so according to a well-defined and uniform federal valuation plan?

If physical valuation be so important to the investor, why may not the task be intrusted to private enterprise? Why need the government take a hand in so vast an undertaking? The answer is almost obvious. A most important consideration is that results should everywhere be standardized, so that comparisons may be made all along the line. Moreover, so long as the method and result is subject to private control, there is the same danger as before that an unscrupulous management may prove faithless to its trust. As a matter of fact, many large corporations, including a number of leading railroads, have within the last few years undertaken this work on their own account. The twofold danger in leaving matters of this sort to private initiative is once more well illustrated by the unfortunate experience of the New Haven Railroad. Already well started upon its downward path, as we now know, the New Haven several years ago employed an ex-chief engineer of the Panama Canal to make a complete inventory of its property. The details were never disclosed; but the results were evidently relied upon to support a continuation of the policy of overcapitalization, then well under way. Subsequently, in connection with proceedings by the state to enforce its laws, a so-called Massachusetts Validation Commission was appointed to determine officially whether the New Haven assets were adequate to entitle its bonds to continuance as a legal investment for savings banks. This valuation was made in accordance with principles entirely at variance in many respects with the established practice of the time. For example, the engineer in charge made no deductions for depreciation of plant, regardless of its age, so long as it was capable

¹ Harrington Emerson, "The Rate Decision," *Review of Reviews*, September, 1914, p. 347.

of rendering adequate service, while still making full allowance for appreciation in the value of land. In other words, reproduction cost entirely new was the basis of the inventory. The railroad was also favored in many other ways, as, for example, by crediting to it the entire cost of abolition of grade crossings, although a large part of this cost had been borne by the state. It is not our purpose, however, to criticize these methods of physical valuation. The point is that this valuation, made upon a basis entirely favorable to the railroad, was afterward used by its management to mislead both the public and the owners of its securities as to the true condition of affairs. The Massachusetts Public Service Commission, after a detailed investigation in 1914, found that the New Haven had expended \$7,800 for the purpose of distributing copies of a certain Wall Street publication containing "an utterly false and misleading statement" to the effect that its assets exceeded its liabilities by more than \$100,000,000. As a matter of fact, the Validation Commission did report something of this sort to be true. But the case would have been entirely different had the inventory been made according to the generally accepted practice then in vogue among the state public-service commissions. All the advantage which attaches to the comparative method in science was denied to the public and the investors in this case, and an opening was afforded for a grave misuse of the material which public investigation had revealed. Now that the federal government, however, has undertaken a physical valuation for all the railways of the United States according to a uniform plan, this danger will in the future be considerably minimized.

It is important that the public be advised in connection with the great program of physical valuation that its service is confined merely to publicity. It does not purport to be in any sense a guaranty of the investment. This point is strongly emphasized in connection with all of the legislation having to do with publicity. The Federal Railway Securities Commission of 1910 very properly called attention to this possible misinterpretation of official examination either of accounts or of assets. As in the case of the pure-food laws, an attempt is indeed made to standardize railroad securities. One should be enabled to know what is being

bought, but no certification is afforded that the purchased security is a good investment. Matters of that sort must be left to the intelligence of the buyer. "The government cannot protect the investors against the consequences of their unwisdom in buying unprofitable bonds, any more than it can protect the consumers against the consequences of their unwisdom in eating indigestible food." It is in accordance with this salutary principle that practically all of the newer public-service commission laws distinctly disclaim any responsibility in the nature of a guaranty of the securities approved for issue.¹ Nor is this done merely for the avoidance of legal liability on behalf of the state. It is very properly a declaration of principle, placing the responsibility for the investment of funds where it properly belongs, upon the shoulders of the private parties concerned. The government undertakes a full and accurate publicity. Facts are spread upon the records. What private individuals may choose to do upon the basis of that presentation of facts is left entirely to their own discretion. That, I take it, is a fundamental principle in the entire domain of public regulation of business.

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¹ Cf. the standard public-service commission law recommended by the National Civic Federation in *Commission Regulation of Public Utilities*, 1914.